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In the Supreme Court of the United States

OCTOBER TERM, 1949

No. 533

THE LINCOLN ELECTRIC COMPANY, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

OPINIONS BELOW

The findings of fact and opinion of the Tax Court (I R. 20-47),[1] together with the dissenting opinions (I R. 47-53) are reported at 6 T.C. 37. The opinion of the Court of Appeals, on its first review of the case (IV R. 107-117), is reported at 162 F. 2d 379. The memorandum and order of the Tax Court

[1] The record on certiorari consists of four separate volumes. Record references will be made by indicating the particular volume by a Roman numeral preceding the letter "R."

(IV R. 47-49), entered after the case had been remanded to it, is not officially reported. The opinion of the Court of Appeals reviewing the second decision of the Tax Court (IV R. 121-126), together with the dissenting opinion of Judge Allen (IV R. 127), is reported at 176 F. 2d 815.

JURISDICTION

The judgment of the Court of Appeals was entered on August 29, 1949. (IV, R. 119.) A petition for rehearing was filed on September 17, 1949 (IV R. 129-141), and was denied on October 12, 1949 (IV R. 143). A petition for a writ of certiorari was filed on January 9, 1950. The jurisdiction of this Court is invoked under 28 U.S.C., Section 1254.

QUESTION PRESENTED

Did the court below err in holding that an expenditure, to the extent that it may exceed a reasonable amount, is not an ordinary and necessary business expense which may be deducted under Section 23 (a)(1)(A) of the Internal Revenue Code?

STATUTE AND REGULATIONS INVOLVED

Internal Revenue Code:

> SEC. 23. DEDUCTIONS FROM GROSS INCOME.
>
> In computing gross income there shall be allowed as deductions:
>
> (a) [As amended by Section 121 of the Revenue Act of 1942, c. 619, 56 Stat. 798] *Expenses.*—
>
> (1) *Trade or Business Expenses.*—

(A) *In General.*—All the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including a reasonable allowance for salaries or other compensation for personal services actually rendered; traveling expenses (including the entire amount expended for meals and lodging) while away from home in the pursuit of a trade or business; and rentals or other payments required to be made as a condition to the continued use or possession, for purposes of the trade or business, of property to which the taxpayer has not taken or is not taking title or in which he has no equity.

* * * * *

(26 U.S.C. 1946 ed., Sec. 23.)

Treasury Regulations 103, promulgated under the Internal Revenue Code:

Sec. 19.23 (a)-1. *Business expenses.*—Business expenses deductible from gross income include the ordinary and necessary expenditures directly connected with or pertaining to the taxpayer's trade or business, except the classes of items which are deductible under sections 23 (b) to 23 (s), inclusive, and the regulations thereunder. Double deductions are not permitted. * * *

STATEMENT

The facts which are pertinent to the issues which the taxpayer seeks to raise by the petition for a writ

of certiorari may be summarized as follows: During the taxable years 1940 and 1941, the taxpayer expended certain sums, $400,008.84 in 1940, and $575,206.43 in 1941, for the payment of premiums on a group annuity policy. In December, 1941, it also transferred the sum of $1,000,000 to a trust which was created at that time for the benefit of certain employees. (I R. 20-21, 23.) The Commissioner's deficiency determination for 1940 ruled that the amount expended for annuity premiums in that year was not an allowable deduction. (III R. 608-609.) Similarly, for 1941, it was determined, both as to the amount expended for premium payments and the amount transferred to the trust fund, that neither was an allowable deduction under Section 23 of the Internal Revenue Code. (III R. 612-613.) Alternatively, the deficiency determination ruled that, for 1941, if the expenditures should be considered as proper liabilities accrued for salaries and wages and for additional compensation, then, to the extent indicated in a schedule attached to the deficiency notice (III R. 621-635), the premium and trust fund payments were "unreasonable compensation" and not deductible under Section 23 (a) of the Internal Revenue Code (III R. 612-613).

The Tax Court, in its original opinion (I R. 20-47), ruled that no part of the payments in 1940 and 1941 for the annuity premiums and for the creation of the trust fund was deductible, it being held that the payments did not qualify for deduc-

tion as ordinary and necessary business expenses under Section 23 (a)(1)(A) of the Internal Revenue Code. The Tax Court did not pass on the question of the reasonableness of the compensation because, in view of its decision, it considered the question moot. The taxpayer filed a petition for review. (I R. 54.) On review, the Court of Appeals reversed the Tax Court, holding that it had been wrong in concluding that the expenditures were not the type of expenses which the statute considers to be ordinary and necessary. (IV R. 107-117.) The case was remanded to the Tax Court for proceedings in conformity with the mandate. (IV R. 117.) On the remand, further proceedings were held in the Tax Court. It construed the mandate of the Court of Appeals as leaving it without jurisdiction to do anything except to allow the full deduction of all these payments and to compute the tax accordingly. (IV R. 47-49.) The Commissioner filed a petition for review. (IV R. 83-85.) On this petition, the Court of Appeals (Judge Allen dissenting (IV R. 127)) held that the Tax Court had misconstrued the mandate and had erred in failing to consider whether the expenditures exceeded a reasonable amount (IV R. 121-126).

ARGUMENT

1. The decision below, in the respect that it is being complained of by the taxpayer, is correct. The Court of Appeals held that an "ordinary and necessary" business expense is deductible under Section 23 (a)(1)(A) of the Internal Revenue

Code, *supra,* only to the extent that the expenditure is reasonable in amount. Where the expenditure exceeds a reasonable sum, the court decided that the unreasonable portion may not be deducted under the guise of a business expense. The case was remanded to the Tax Court to permit it to make a determination of the factual question whether the expenditures here were reasonable in amount. (IV R. 124-126.)

If it be assumed with the court below that the expenditures in question fall within the general category of expenses if it be assumed further, as did the court below, that the payments were ordinary and necessary in nature, and which are not compensation for services rendered (IV R. 121-124) (assumptions with which we cannot agree),[2] it seems fairly plain that the court correctly applied Section 23 (a)(1)(A) in not permitting the deduction in full of expenditures which might be unreasonable in amount.

The court below stated that (IV R. 124) "* * * the element of reasonableness is inherent in the

[2] The Government contended, successfully in the Tax Court at the first hearing, but unsuccessfully in the Court of Appeals, that these expenditures were not the kind of ordinary and necessary business expenses that are deductible at all under the statute. The Commissioner also asserted, alternatively, that if these were ordinary and necessary expenses, they were intended as compensation for services rendered and were excessive compensation to the extent indicated in the deficiency determination. The Court of Appeals, in its second decision, ruled that the payments were not compensation for services rendered, but nevertheless constituted deductible business expenditures of a non-compensatory nature. The Commissioner believes that the Court of Appeals erred in its rulings in both respects.

phrase 'ordinary and necessary.' " It further observed that Congress never intended "* * * to automatically allow as deductions operating expenses incurred or paid by the taxpayer in an unlimited amount." This is the proper construction of the statute. In *Botany Mills* v. *United States,* 278 U. S. 282, 292, under the Revenue Act of 1916 (even before Congress added to the statute the clause providing for the deduction of a "reasonable" allowance for salaries or other compensation) this Court held that "extraordinary, unusual and extravagant amounts" purportedly paid as compensation, are not in reality payments for services and "cannot be regarded as 'ordinary and necessary expenses' * * *." Thus, while the taxpayer here is contending that there are no limitations under the statute, not even that of reasonableness, on the amounts which a taxpayer may deduct when making expenditures for ordinary and necessary objectives, this Court held to the contrary in the *Botany Mills* case. Further, the decisions of this Court in *Welch* v. *Helvering,* 290 U. S. 111, and *Deputy* v. *duPont,* 308 U. S. 488, with respect to the meaning of the phrase "ordinary and necessary expenses" are inconsistent with any notion that an unreasonable expenditure for any objective could be either "ordinary" or "necessary."

The lower court's construction of the statute is also confirmed by this Court's observation in *Commissioner* v. *Flowers,* 326 U. S. 465, 470, that

to be deductible as an ordinary and necessary business expense, a travelling expense "* * * must be a reasonable and necessary travelling expense, as that term is generally understood." This requirement that the travel expense be reasonable in amount is reiterated in Section 19.23(a)-2, Treasury Regulations 103, and has been stated in all Treasury Regulations, beginning with Article 101 (a), Treasury Regulations 62, promulgated under the Revenue Act of 1921. The statute has thus been long interpreted so that the words "ordinary" and "necessary" incorporate a limitation that the claimed deduction be reasonable in amount. Further, while the rental clause of Section 23 (a)(1)(A), like the travel expense clause, does not contain its own limitations of reasonableness, it has been held that excessive rental payments would not be deductible because such a limitation is contained in the "ordinary and necessary" phrase. *Limericks, Inc.* v. *Commissioner,* 165 F. 2d 483 (C.A. 5th).

The decisions and the administrative construction, accordingly, fully support the decision below in its holding that, if the particular expenditures here should be found by the Tax Court to be unreasonable in amount, they are, to the extent that they exceed a reasonable sum, neither ordinary nor necessary business expenses under Section 23 (a)(1)(A).

While the taxpayer contends that these authorities were misunderstood by the court below

(Br. 25-26), the attempted distinctions all rest on the assertion (Br. 24, 26) that there is a difference between the amount of an expenditure and the "*class* or *kind* of expenditure" involved. The short answer to all this is that such a difference does not exist; an expenditure which exceeds a reasonable amount cannot be classified as an ordinary and necessary business expense, to the extent that it exceeds reasonable limitations.

The taxpayer also complains, at length, that the decision below confers novel and extensive powers on the Commissioner which Congress never granted. (Pet. 12-16, Br. 24, 27.) The court below, contrary to the taxpayer, did not conclude (Pet. 13) that the Commissioner possessed the "power to say which, and how much, if any, of the 'ordinary and necessary expenses' of carrying on a trade or business shall be allowed," nor did the court constitute (Pet. 12-13) "The Commissioner * * * a super-manager for the nation's business." The Commissioner, of course, has the initial duty of determining whether an expense is unreasonable and, consequently, whether it fails to qualify as an ordinary and necessary business expense, just as he must always determine whether any section of the statute has been complied with in every respect. His determinations, however, are always subject to review by the courts in the manner provided for by Congress. If the Commissioner errs in concluding that a part of a particular expenditure is not deductible, his administrative

action is subject to correction by the courts, no matter whether he was wrong with respect to its reasonableness or whether he was wrong in some other respect. It should have been apparent to the taxpayer that the court below did not make the Commissioner a "super-manager" of the nation's business from the very fact that this case was remanded to permit the Tax Court, not the Commissioner, to pass on the reasonableness question.

2. There is no conflict in decisions. The taxpayer does not assert that there are any conflicting decisions on the merits of the controversy, namely, the proper construction of Section 23 (a)(1)(A). Indeed, as we have shown, the decision below follows the decisions of this Court with respect to the meaning of the statute. The taxpayer contends, however, that the decision conflicts with *Metropolitan Co.* v. *Kaw Valley District,* 223 U. S. 519, and *Briggs* v. *Pennsylvania R. Co.,* 334 U. S. 304 (Pet. 16-17; Br. 27), it being contended that the court below, after its first review of the case (Pet. 16) "* * * has reopened, and added qualification to, a prior final judgment of which no review or other correction was sought."

The assertion of this conflict, and the taxpayer's serious charge that the court below (Pet. 17-18; Br. 28) "departed from the accepted and usual course of judicial proceedings," all turn on the unwarranted premise that, after the first re-

view by the Court of Appeals and the issuance of the mandate (Br. 27), "nothing remained for the Tax Court to do but compute the tax." In this the taxpayer is mistaken. The Court of Appeals in its first opinion (IV R. 107-117) did not determine that the taxpayer was automatically entitled to deduct the full amount of these expenditures. The decision was only to the effect that the Tax Court had erred in concluding that these expenses were not the type of payments which were ordinary or necessary and in holding that they were not deductible at all under the statute. Indeed, the opinion on the first review (IV R. 113) made it plain that the question being decided was "whether, as a matter of law, the disallowed deductions constituted ordinary and necessary expenses * * *." That factual matters still remained for the Tax Court was made explicit by the court's express statement that (*ibid.*) "* * * in any event we will not be obliged to determine their reasonableness, for that is concededly within the exclusive province of the Tax Court and it has given no consideration to it * * *."

In view of the court's decision, it is clear that the mandate did not require the Tax Court merely to "compute the tax" on the assumption that the taxpayer was automatically entitled to deduct the *full* amount of the payments. The mandate only compelled the Tax Court to assume, as a matter of law, that the expenditures fell into the class of ordinary and necessary business expenses which

are of a deductible nature. The Tax Court was still required to determine the factual question whether any portion of the expenditures was unreasonable and, to that extent, not an allowable deduction. The first opinion of the Court of Appeals, as we have already observed, expressly stated that this was to be the function of the Tax Court.

The present contention of the taxpayer, it will be noted, was also advanced below and was expressly rejected by the court; the second opinion stated (IV R. 126):

> As a matter of strict interpretation of our ruling, the taxpayer is incorrect in stating that we held the payments to be ordinary and necessary expenses and deductible in full. What was actually decided was that the Tax Court was in error in its interpretation of the law and in its ruling that the payments were not of a deductible character. We so stated in the closing sentences. The ruling of the Tax Court was reversed. The case was remanded to the Tax Court for proceedings in conformity with our opinion. This had the effect of restoring to the Tax Court all the authority that it possessed when the case was first before it, except that it was required to conform to the ruling of the Court. *Swenson* v. *Commissioner,* 69 Fed. (2d) 280, C. A. 5th; *Houston* v. *Commissioner,* 53 Fed. (2d) 445, C. A. 3rd. * * *

Since the taxpayer is wrong in the assumption that nothing except a mathematical computation

of the tax remained for the Tax Court under the first mandate, it is also wrong in its contention that the Court of Appeals lacked authority to correct any errors committed by the Tax Court after the case had been remanded to it; accordingly, the cases relied on by the taxpayer for the asserted conflict are not in point. The contrary is true of the authority of the reviewing court in these circumstances. *Swenson* v. *Commissioner,* 69 F. 2d 280 (C.A. 5th). Indeed, the Court of Appeals would have had authority in its second decision to correct errors which it itself may have committed in its first decision. *White* v. *Higgins,* 116 F. 2d 312, 317 (C.A. 1st). It will be noted that in the present case the Commissioner asserted below that the Court of Appeals had erred in its first decision; the court refused to disturb its prior ruling, not on the ground of lack of jurisdiction, but because it believed its prior ruling to be correct. (IV R. 121-124.) Furthermore, this Court possesses authority to correct errors committed by the court below, even in its first decision. *Hamilton Shoe Co.* v. *Wolf Brothers,* 240 U. S. 251; *Panama Railroad* v. *Napier Shipping Co.,* 166 U. S. 280; *United States* v. *A. S. Kreider Co.,* 313 U. S. 443; *Burnet* v. *Flannery Bolt Co.,* 286 U. S. 524. Accordingly, the authority of the court below to correct errors committed by the Tax Court in the course of its proceedings on the mandate is an *a fortiori* matter.

The taxpayer's further assertion (Pet. 17-18, Br. 23, 28) that the court decided a matter which was not previously in issue, is equally wrong. Since an ordinary and necessary business expense may not exceed reasonable limitations, that issue was implicitly raised at the very outset by the taxpayer's petition to the Tax Court which, in controverting the Commissioner's deficiency determinations, asserted that these expenditures were deductible as ordinary and necessary business expenses. (I R. 4-13.) To succeed, the taxpayer was required to establish all elements necessary to the claimed deduction. *Helvering* v. *Gowran,* 302 U. S. 238; *Irish* v. *Commissioner,* 129 F. 2d 468 (C.A. 3d); *Alexander Sprunt & Son* v. *Commissioner,* 64 F. 2d 424 (C.A. 4th). The taxpayer, accordingly, was not entitled to prevail in the Tax Court in the first instance except by establishing that the expenditures were *of the type* which are ordinary and necessary, and by also establishing that the particular *amounts* paid were ordinary and necessary, that is, that they were reasonable in amount. This issue having been raised by the taxpayer, there was no need for any particular pleadings by the Commissioner to require a decision on the point. *Burton-Sutton Oil Co.* v. *Commissioner,* 161 F. 2d 558 (C.A. 5th).

Even if there had been no specific issue on the question of reasonableness, the Commissioner, having been successful in the first instance in the Tax Court, was entitled to urge any grounds in

the reviewing court to sustain the decision below. *Helvering* v. *Gowran,* 302 U. S. 238; *Hormel* v. *Helvering,* 312 U. S. 552. In defending the Tax Court's decision on the first review in the Court of Appeals, the Commissioner's brief (p. 45) argued that the expenditures were so extraordinary in amount that they could not qualify for deduction as ordinary and necessary business expenses. The issue was thus properly presented to the Court of Appeals. While, because of the lack of appropriate findings on the part of the Tax Court, the Court of Appeals refused to decide this issue as a matter of law, there is no doubt that the issue remained alive when the case was remanded to the Tax Court and that it should have been decided by it pursuant to the mandate. That is the substance of the second decision of the Court of Appeals. (IV R. 121-126.)

It is true that in the proceedings in the Tax Court pursuant to the mandate, the parties were primarily contending over the issue whether the reviewing court's first decision still left open the question whether these were compensatory payments, an issue which the Tax Court (IV R. 47-49) and the Court of Appeals (IV R. 121-124) determined adversely to the Commissioner. However, the Commissioner never waived the over-all issue of reasonableness (cf. *Helvering* v. *Wood,* 309 U. S. 344), and the Court of Appeals was empowered to reverse the Tax Court for implicitly deciding this issue contrary to the correct mean-

ing of the statute (*Helvering* v. *Gowran,* 302 U. S. 238; *Hormel* v. *Helvering,* 312 U. S. 552; *Helvering* v. *Richter,* 312 U. S. 561).

3. The only issue determined against the taxpayer by the court below, namely, whether an expense can be unreasonable in amount and, at the same time, an ordinary and necssary business expense under Section 23 (a)(1)(A), was properly decided. It should be pointed out that this issue is only one aspect of the entire case, and that the case also involves other closely related issues decided against the Commissioner (see fn. 2, *supra,* p. 6) including the question whether the Commissioner and the Tax Court were wrong in determining that no part of these expenditures was deductible at all as ordinary and necessary business expenses. It is clear, accordingly, that if this Court should decide to grant the taxpayer's petition, the case could not be properly reviewed without a consideration of all the elements of the decision below. Since this case does not seem to warrant further review by this Court, no petition for a writ of certiorari will be filed on behalf of the Commissioner to review the aspects of the decision rendered adversely to the Government. However, if the taxpayer's petition should be granted, the Solicitor General intends to file a cross-petition with respect to the matters decided adversely to the Government in order that this Court may have an opportunity to afford a full and complete review of the case.

CONCLUSION

The decision below is correct. No conflict in decisions exists. Further review of this case would not be warranted. Accordingly, the petition for a writ of certiorari should be denied.

Respectfully.

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